



*Michael C. Schlachter, CFA  
Managing Director*

June 2, 2008

Ms. Anne Stausboll  
Interim Chief Investment Officer  
California Public Employees' Retirement System  
400 P Street, Suite 3492  
Sacramento, CA 95814

Re: Credit Enhancement Program Increase

Dear Anne,

You requested Wilshire's opinion regarding the proposed expansion of the internally-managed Credit Enhancement Program from a capacity of \$5 billion to \$10 billion and the removal of the restriction on single transactions to \$250 million.

### **Recommendation**

**Wilshire recommends that the Investment Committee accept Staff's request for an expansion in the size of the Credit Enhancement Program from \$5 billion to \$10 billion and the removal of the individual investment limit.**

### **Background**

The Credit Enhancement program was launched in 2005 with an initial capacity of \$5 billion. To date, Staff has been cautious in extending CalPERS' credit to external parties and has only committed \$2 billion of that capacity. From program inception through mid-2007, CalPERS had many competitors in this market, resulting in a low potential for gains, and Staff was careful to invest in only the most profitable opportunities.

Since mid-2007, the "credit crunch" currently underway has resulted in considerable strain on debt issuers and much greater potential for CalPERS to achieve better returns.

Our understanding from Staff is that the proposed increase has been reviewed by the rating agencies and will result in no change in CalPERS' credit rating. In light of this, we believe that the expansion in the size of this program is appropriate to better allow CalPERS to profit from this increasingly lucrative market.

Obviously, doubling the size of the program doubles the potential impact of defaults, and this risk needs to be considered by the Investment Committee. However, to date,

Ms. Anne Stausboll

Page 2

CalPERS has had no defaults in this program and all debt issues CalPERS credit enhances are backed by the issuing municipality or other government entity. As a result, while we recognize that defaults are always a possibility, the likelihood of experiencing one is extremely low.

The removal of the \$250 million individual investment limit is a bit more complicated. The program has a number of concentration limits (geographic, sector, etc.) that are expressed as a percentage of the program, not as actual dollar amounts. The removal of this limit brings this policy into compliance with the other policies that have been revised systemwide over the last two years that now rely almost exclusively on percentage limits.

The removal of the limit would appear prima facie to increase the potential for concentration in the program, but, in actuality, this was always a limit without “teeth”. An issuer could break a debt offering into several transactions, and the \$250 million limit, as written, would apply to each transaction separately. As a result, if Staff wanted to enhance \$1 billion from a single issuer, assuming that amount was allowed under the concentration limits, they could do so if they committed the \$1 billion over the course of four issuances. As a result, given that this was a written policy limit that had no actual impact on the management of the portfolio or the resulting risk to CalPERS, we have no objection to its removal.

If you have any additional questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Schlachter", with a long horizontal flourish extending to the right.

Michael C. Schlachter, CFA